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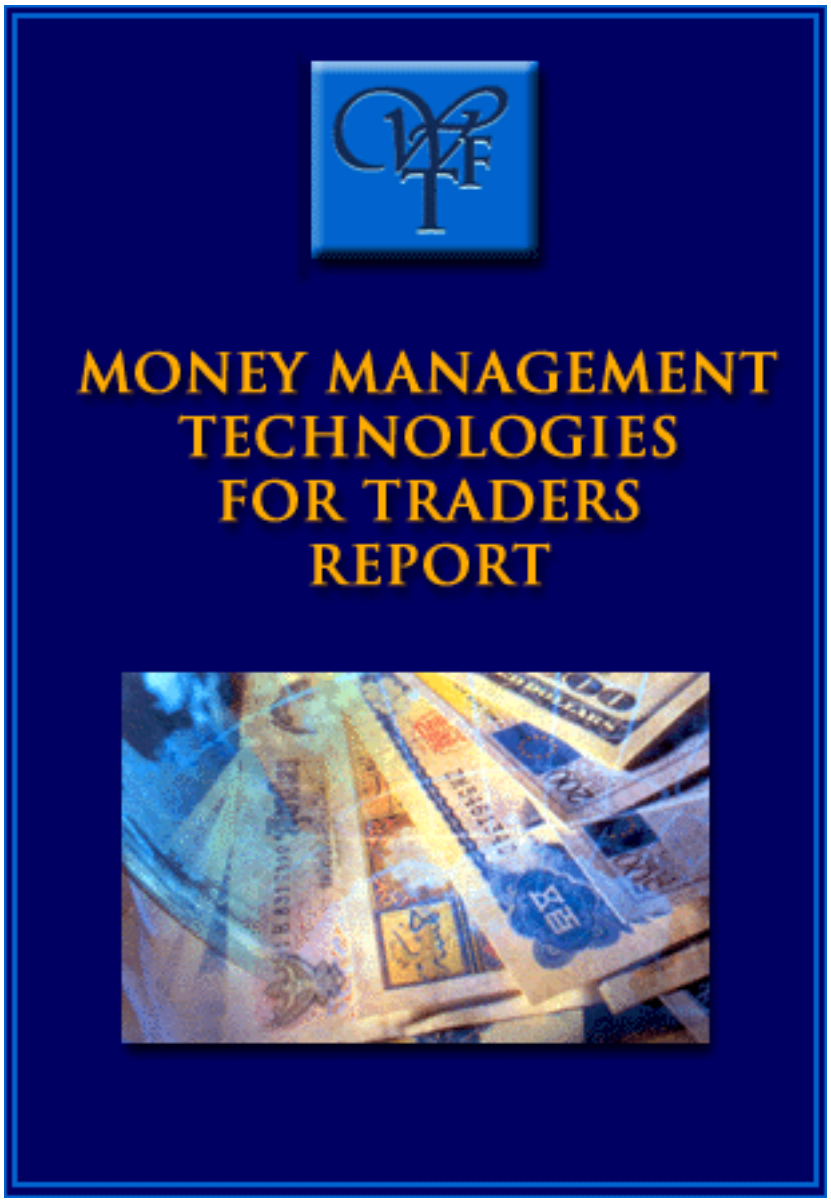

Money Mangagement Technologies Report

MONEY MANAGEMENT

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RISK CONTROL FOR TRADERS

There is one thing more important than any method of trading anyone could ever teach you. Money management and risk control are critical to trading success. It is not complicated, but there are some very specific rules that you should follow. Unless a trading system is 100-per-cent accurate in all cases, a sound system of risk management and risk control has to be part of it. If you have poor money management skills, you could have the best trading system in the world, one that is right 90% of the time, and you will still lose all of your money. On the other hand, with good money management skills, you could have a fairly inaccurate system, and still get respectable returns. Money management is so important that studies have shown that up to 90% of the variance in fund manager performance can be directly attributed to it.

Without a proper money management plan, it is difficult to cut losers and let winning trades run. Many traders also overstay when the market goes against them, they are not flexible enough to change their minds or opinions when the trend is clearly against their positions. Instead of limiting their losses, traders tend to add to losing positions.

The first thing that you have to decide is the size of your trading account. It is advisable that your trading account must be separate from your investment account. It should be a small portion, perhaps 10% to 20% of your total investment account. This is your high-risk money and you must recognize that trading is a high-risk business. If you are successful, that is good. If you are not, you do not want to get badly hurt.

Never mix your trading account with your investment accounts. Go to the extreme of having your trading account with a different brokerage firm.

What is money management and risk control? Money management and risk control is the portion of one's business plan (trading system) that tells you how much you can risk on one trade. What amount of risk should you be willing to take? A proper money management component to your business plan not only assures your longevity simply by not allowing obscenely large positions, but also by removing significant psychological barriers in trading. Larry Hite from the book Market Wizards (which we would recommend you all read) by Jack Schwager says:

"Never risk more than 1% of your total equity in any one trade. By risking 1%, I am indifferent to any individual trade. Keeping your risk small and constant is absolutely critical." Larry Hite.

Mr. Hite manages futures, and the risk control modules used are slightly different, never-the-less, the principles are much the same. Incidentally should you be thinking you can not make good returns taking such small risks you should know that when Market Wizards was written (1988) Larry Hite's funds had a compounded average yearly return of 30%. Our return goals are higher than those set by Mr. Hite. As such we must be willing to take a bit more risk per trade then he does. Remember the principle however that one trade should not matter. The risk control module we recommend for the techniques you will learn here is 2%. You could go up as high as 5%, but the swings in your account, and thus potentially your state of mind, will be large.

What does this 2% risk module mean? We will use an example of a $50,000 account for the purposes of illustration. You find an opportunity in XYZ as a short if it trades below 55 1/8, and your stop according the methods you use should be

56 5/8. This means your risk per share is $1.50. At this point, you must determine how much you can risk according to your risk control plan. In this case, you will be risking $1000, which means if you are wrong and are stopped out, you will lose $1000.

Risking $1000 you can trade up to 666 shares of XYZ. In this case, we would advise rounding down to at least 650, and probably 600 just for ease of executions sake. However, if you want to be absolute on your risks, which isn't a bad plan, you can trade 666 shares. Just remember to never round up. If you do any rounding, make it down as this will not put you in the uncomfortable position of risking too much of your capital on one trade.

Using this risk module each time you make or lose money the absolute dollar amount risked will of course change, but it is important once you have a percentage you are comfortable with to stick with it. As an example, say the XYZ trade doesn't work out and you take your stop, your account now has $49,000 in it. On your next trade, you wish to buy ABDC at a price of 21 3/4 with a stop of 20 7/8. You can risk $980 on this trade. Each share of ABCD has a risk of $0.875. This means that using a 2% risk module you can take up to 1120 shares. We will assume this trade works out and you sell 3 days latter at a price of 23 1/2 for a gain of 1 3/4 per share, we are also assuming, that this is the only trade you've made during this time frame for the sake of simplicity. Assuming you took a position of 1100 shares this brings your account up to $50,750.

The next trade is in VVV, it is a buy at 45 1/8 and your stop is a rather wide one at 42 1/4. This puts your risk at $2.875 per share. With $50,750 in your account, you will be risking $1015. As such, you can take a position of 350 shares. Two days later when you sell VVV at 50, this brings your account up to $52,456.25, which means that you will be risking $1049

on the next trade. As you can see, after three trades using this module your account is up a very respectable 4.9125%. If this represented one months' worth of trading, you would be on track to return at least 58.9%, a number most fund managers would sacrifice their first born to achieve.

What would happen if we used an arbitrary number of shares in each position, say 300 shares per trade as many traders do. You would vastly under-perform, after these three trades you would have an account size of $51,537.5 for a return of 3.075%, which is very respectable, but not as good as you should have done. The real risk however with this arbitrary system is that it is quiet possible you will find yourself in a position of risking entirely too much money on one trade. Say you want to trade something like Amazon.com. Stocks such as Amazon very commonly have stops of $10 or more. In this case you could be risking $3000 on one trade with an account of $50,000. This is a 6% risk, which is entirely too large a position to consider taking. It is this kind of position, that will put you out of business.

Keeping careful track of your positions is essential. Keep a trading notebook. It can be a file in your word processor or just a scratch pad. Keep it organized, trading is a business.

When you enter a position, either long or short, you should have a price target for the trade. Put into your trading notes what the target is and why you decided to enter the trade and what your entry price is. Have a time frame for the trade, that is you are expecting to be in the trade for some number of days or weeks.

Do not concentrate your trading account in too few stocks, you must diversify. Five stocks is better than one or two and ten is better than five. Try to have all your positions of about equal dollar size. That way, if you have a loser, the total loss is small in relation to your trading account.

Especially if you are inexperienced always use stop loss orders. By placing a stop order you are defining the amount that you are willing to risk on a trade. Placing stops is tricky. In general, if you are initiating a trade in a stock that you expect to move out of a consolidation or trading range set your stop below the opposite side of the consolidation. If you are trading a stock that is strongly trending up, set your stop below a moving average for the stock price. If you are short then do the opposite. If you don't know what moving average to use try one between 20 and 40 days. The reason for a stop is to avoid a disaster. If you set your stop too tight you can be prematurely closed out of a trade that would otherwise be profitable. Put your stop decision in your trading notes.

Closing out a position is much more difficult than opening a position. Remember that we are trying to hit a lot of singles and doubles, not home runs. Since you have a target for the trade, you can put an open order at the target price. If your position is several hundred shares, you can scale out of your position. That is you can sell 1/3 of your position at your target price, the second 1/3 a little below your target price and then keep the last third for a better price. Time is another reason to close a position. When you opened the position you had a time frame in mind. If one half of the time has elapsed and the stock has not moved, the probability is that you have a potentially bad trade and you should close it out. If the position is a real mover you should consider moving both your target and your stop. That way you can extend your profit and the stop will take you out of the trade if it reverses.

Above all don't be afraid to take a loss. Just try to keep it small. You do not want a bad trade to turn into a long-term investment. Equally important, do not be afraid to take a profit. Leave some money on the table for the next guy. Don't get greedy and don't fall in love with a stock. We are looking for reasonable profits.

Don't get emotional about the market. Lack of experience in the market causes many traders to become emotionally and/or financially committed to one trade, and unwilling or unable to take a loss. Emotions and FEAR are the enemy. They must be eliminated at all cost by making all your trading decision before the market is open. You keep your head must be clear during trading hours and can stay focused on your Game Plan and the opportunities presented in the market. This will prevent you from panicking. Many people trade with their hearts instead of their heads. For some traders, adversity (or success) distorts judgment. That's why they should have a plan first, and stick to it. Especially after a winning streak when traders are feeling confident that they can beat their systems. The result is emotional trading, which also leads to losses. Emotion makes many traders hold a loser too long. Many traders don't discipline themselves to take small losses and big gains.

There is also a striking inability to stay with winners. Most traders are too willing to take small profits and, therefore, miss out on big profits. Most successful traders lose on 60% of there traders but they make the 40% count and its usually only just a few trades a year which really makes them their money. This takes patience. It sounds simple, but it takes discipline to trade correctly. This is hard whether you're losing or winning.

Before making a trade you should: Set objectives - define all outcomes and what you will do in each possible event. Determine a dollar amount or percentage you are willing to risk. Determine when you will take profits.

FOLLOW your trading plan & risk guidelines RELIGIOUSLY. Define a screening method for trade selection.

- Know how much you are willing to lose
- Never have a drawdown of more than 12% of initial capital. It is EXTREMELY difficult to come back from a loss of investment capital greater than 25%. So, if you lose 25% of your capital, you will need a 33.3% gain to be back to even (because you are starting from a lower capital base).

At the present time, the market is very price volatile. Large moves and large reversals are happening daily. Use discipline and money management and your trading method should work in your favor. Also remember that nobody is perfect and you are going to make mistakes. You will always make them. Try not to repeat them. At the end of the day mentally review your trades and positions.

Understand what you did right and wrong. Losing money because you were wrong is not a mistake, losing money because you didn't follow your rules is a mistake. When reviewing your positions look at them with an unbiased view, ask yourself what you what do if you had no position. For example if you are long crude oil, try looking at as if you were thinking of entering into a new position, would you go long, short, or stay out. Its important be honest here and not married to your position. If you can do this, you'll be surprised how much clearer you'll see the markets.

Commissions are a significant cost for active traders. Brokerage houses are in business to make money, and in most cases, apply commissions to your buy and sell orders. Consequently, an active account will provide good returns only if your trading system scores on the odd winner. Without a few home runs, it’s tough to see real profits with just in-field hits.

For an investor with a $25,000 account, transaction costs for a year of trading could exceed $2,500, assuming that 20 or so positions are taken during the year. Obviously, this kind of

investor should seek out a good discount broker. Savings in transaction costs could improve your returns substantially.

By combining the information above with these additional trading tips below, you will virtually eliminate any risks of losing all your trading capital and should be able to make excellent profits from trading:

1. **Never risk more than 2 % of your trading capital on a single trade.** Smaller accounts between $5,000 and $10,000 may have to go slightly higher.

2. **Always use Stop Loss Orders** to protect capital whenever you make a trade, and move them to protect profits. Most traders don't really use stops properly. Any one who trades with a tight stop will be stopped out in a normal market retracement. Stops should be placed at least 2 standard deviations from where the market is. They should also be placed using a higher time frame.

   If you trade using daily data, look at weekly data to place your stop. Stops should not be moved when the market gets close them. Too many traders place stops then don't want to take a loss and keep moving their stops as the market gets closer. Stops should also be used in order to not let a winning position get away from you. In a trending market they should be moved with the trend, this will eventually lock in some profits. Even if you don't like to place stops, you should have a predetermined point at which you'll get out of the market, stops help you do this.

3. **Never over trade.** Many traders over trade with undercapitalized accounts. Traders often try to carry too big a position relative to their available capital, and trade too frequently for the size of the account.

4. **Never let a profit run into a loss.** As soon as a trade becomes profitable, move your stop loss to lock in profits.

5. **Cut your losers.** Many traders can't (or don't) take the small losses and admit they are wrong. They often stick with a small loser until it really hurts, then take the loss.

6. **Always go with the trend**, unless you are positive it is over. Trading against the trend is a common mistake, especially without reasonable stops.

7. **"When in doubt, get out."** If you are unsure of the market position, it is safest to exit with a guaranteed profit or small loss.

8. **Avoid stagnant and volatile markets** and trade in markets that are trending with a daily volume of at least 100,000 plus. These markets will result in bad fills, limit moves and erratic price movements usually against your position, which results in your stops being blown through.

9. **Trade in a variety of different markets to spread risk**.

10. **Create a surplus account.** This is one of the most important tips. When you have made some profits, place them here to use only in an emergency.

For more information about trading successfully, or to:

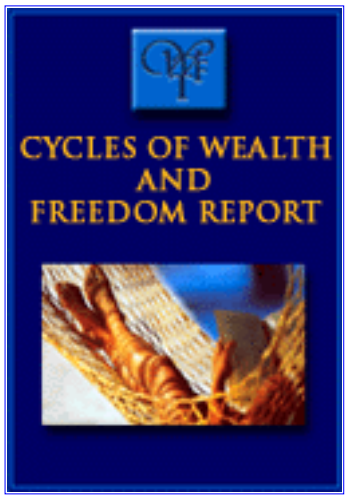
- Discover how to use the underlying cyclic structure of the markets to make consistent profits in a bull or bear market...

- Have the freedom and flexibility to travel, live and trade from anywhere in the world…

- Have unlimited FREE access to professional charting and analysis software...

Please see the **Cycles of Wealth and Freedom Report and Indicator Package**, www.stangrist.com/CyclesReport.htm which Stan Grist personally developed over several years and

uses with amazing results to build wealth. Find out how **YOU** can too.



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Wealth & Freedom Technologies brings you cutting-edge information about what really works. You will find options, strategies and support, empowering you to break loose and live the life you've dreamed of.

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***businesses that earn you money 24/7, while you enjoy the freedom to live your life*.**

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